



## Memorandum # 6/2007

Commonwealth of Massachusetts | Public Employee Retirement Administration Commission  
Five Middlesex Avenue, Third Floor, Somerville, MA 02145  
Ph 617 666 4446 | Fax 617 628 4002 | TTY 617 591 8917 | [www.mass.gov/perac](http://www.mass.gov/perac)  
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Joseph E. Connarton, *Executive Director*

To: All Retirement Boards

From: Joseph E. Connarton, Executive Director

Subject: Various Investment Issues

Date: January 16, 2007

First of all, we wish to remind all boards of the necessity to comply with the regulations (840 CMR 16.07 (1)(2)(3)) that require periodic performance and strategy review meetings with all investment managers. Once again, we would appreciate written confirmation at some point during the year that all such reviews are either scheduled or have been completed.

As you know, periodic review meetings are a fundamental aspect of the relationship between investment managers and their public pension plan clients. When logistic or other circumstances prevent a manager from attending a board meeting, conference calls are a viable and acceptable alternative, but they should be the exception rather than the rule.

In the most basic aspect of these reviews, boards should use the meetings to ascertain that managers are doing, what they said they would do and to determine how well they are doing it. At these reviews, board members should not hesitate to ask even the most basic of questions. Board members and/or their consultants should also examine periodic portfolio listings and transaction journals and should freely question whether certain held securities are consistent with the portfolio guidelines and whether certain trading patterns or turnover rates seem unusual. Exposure to investment disappointments can sometimes be avoided by simply looking at managers' portfolios and questioning something that doesn't look quite right.

In making its annual determination whether a manager is satisfactorily fulfilling its mandate, a board should question the retention of any manager who has failed to outperform its benchmark over a reasonable period such as three years. In such instances, boards may decide to search for a more successful active manager or, if they are not confident about finding an outstanding active manager, they may choose to achieve benchmark performance at a fraction of the cost of active management by hiring an index manager. PERAC has no policy or opinion concerning the use of index funds versus actively managed funds but, particularly in asset classes like large cap equity that are seen as very efficient, index funds are widely used by public pension plans of all sizes. Sometimes, as in 2006, less than half of all active managers outperform index funds.

Systems that hired investment consultants in 2002 are reminded of Regulation 26.04(3) which requires re-certification of consultants every five years. As explained in PERAC Memo #9/2004,

re-certification does not require a new search process but simply a determination by the board and the subsequent submission of updated regulatory forms.

PERAC has frequently and consistently advised systems about the importance of achieving as much diversification as possible both within and among asset classes. Although 2006 was a year of above-average gains for stocks, it was another in the recent succession of years where systems that invest predominantly in equities and fixed income may not have done as well as those that had strong exposure to nontraditional asset classes. While PERAC is supportive of the local systems' right and ability to invest on their own, it is, nevertheless, a fact that, because of its size and its clout, the PRIT Fund can invest in certain asset classes and gain access to top-tier managers in those asset classes that are beyond the scope and reach of most small to medium-sized plans. It's impossible to predict whether some of the alternative asset classes that have worked so well for PRIM in recent years ( such as emerging markets, real estate, timber, and private equity ) will continue to shine, and some of these asset classes are clearly less liquid and/or more volatile than traditional stocks and bonds. Nevertheless, diversification has proven to be successful over time and boards should at least examine whether their current portfolios are as diversified as possible.

In today's challenging investment environment, where expected returns from the traditional asset classes may be insufficient for a retirement board to achieve its actuarial rate of return over time, institutional investors have not only begun investing in hedge funds but are also considering totally new products and strategies in their search for elusive "alpha" (i.e., returns in excess of a particular market benchmark, or the value added by a manager) and "absolute return" performance that is uncorrelated with the returns of the major markets. Like hedge funds, many of these new strategies involve short-selling and/or use of derivatives, both of which could be at odds with PERAC Investment Regulations. Nevertheless, if after a search process for one of these type of products, the retirement board and its consultant are satisfied with the investment manager's organizational strength and track record and are comfortable with the risk controls inherent in the product, boards may use the supplementary regulation process to request PERAC authorization. A number of boards have successfully done so over the past few years. Boards are encouraged to request feedback from PERAC prior to commencing searches on such "new age" products.

Investment Regulations 19.01 (4) and (8) contain limits on the percentages of total portfolio assets that can be allocated to real estate and alternative investments. If, as the result of an asset allocation study, retirement boards wish to exceed either or both of the limitations contained in those regulations, they may request exemptions from these regulations through the supplementary regulation process.

Boards are reminded of Regulations 19.01(6) and (10), which also pertain to investment in real estate and alternative investments partnerships. These regulations state that the board's investment should not constitute more than 10% ( and all Massachusetts public retirement systems not more than 50% ) of the partnership's assets, and that not more than 20% of the funds in the partnership be invested in a single investment.

Boards should also review Regulation 21.01 (Prohibited Investments) and use the supplementary regulation process to request exemption from any of its provisions.

Boards that have not submitted a revised and updated Statement of Investment Objectives in several years are reminded of Regulations 18.01, 18.02, and 18.03. In addition to the regulatory requirement, completion of these forms should be a constructive exercise for boards in terms of specifying the objectives, policies, characteristics, and risks inherent in their investment programs.

As we've previously stated, investment managers frequently call PERAC to seek clarification on confusing questions that appear on systems' RFPs, such as those that ask whether prospective managers are "PERAC-approved" for the particular asset class. Once again, it must be emphasized that there is no separate process for managers to obtain "PERAC approval". The list of managers distributed quarterly by PERAC simply lists those managers in certain asset classes that have been hired by one or more systems (and granted exemptions by PERAC) and whose products remain open to new investment. The list does not in any way imply PERAC's approval of the manager. The exemption process does not apply at all to domestic equity and fixed income. As is stated in the memorandum that accompanies the quarterly manager listings, boards are free to consider managers not on these lists in their search processes. If boards are simply trying to ascertain whether prospective managers have existing Massachusetts public fund accounts, please try to ask the question in a more concise manner. The PERAC Investment Unit is pleased to offer assistance to systems in the preparation of their RFPs.

A matter of frustration to us and to all parties involved in Massachusetts public retirement systems is the continued existence of the statutes pertaining to Northern Ireland and South Africa. Unlike our practice regarding the tobacco restrictions, a list of securities that would violate these statutes is unavailable. Furthermore, in the extremely unlikely event that a violation is found, there is no penalty beyond the manager being expected to "bring the portfolio into compliance by divesting in a prudent manner."

Our goal as regulators is to ensure that the plans we regulate are able to compete against other plans and to achieve their investment goals with a minimum of regulatory restrictions and bureaucratic delay while also complying with the fundamental requirements of our regulations and Chapter 32. We must make sure our regulations are consistent with evolving practices within the investment management industry and in institutional portfolio management. We must also enforce the regulations with fairness and uniformity. Overall, we believe our regulations and our practices in enforcing them have worked well but if and when a retirement board feels that a particular regulation or PERAC policy is unfair, we welcome your feedback. In such cases, please give us comments that are as specific as possible, such as whether PERAC's treatment of certain investment situations might be more restrictive than regulations in other states or why a particular regulation is making it unreasonably difficult for the board to achieve its investment goals.

As we have clarified many times, our regulations do not permit follow-on real estate investments except in certain circumstances. Follow-on investments for alternative investments (venture capital, private equity, et al) are permitted under the terms of Investment Guideline 99-3.

Nevertheless, because of the very wide disparity in returns among managers in this asset class, boards are encouraged not to use this guideline (which had been adopted during the heady and hectic period that preceded the bursting of the technology bubble) simply as the easiest way to make further investments in alternative investments. During the current period when there is not the pressure to make quick commitments to partnerships as there was in the late 1990s, it may well be worth the effort to issue an RFP for the purpose of identifying and evaluating other managers who may be in the process of marketing new funds.

For further assistance on these or any other investment matters, retirement boards are encouraged to call Investment Director Robert Dennis at 617-4446 ext 922.